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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 544

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

LINCOLN SAVINGS AND LOAN ASSOCIATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 39–74) [1] are reported at 51 T.C. 82. The opinion of the court of appeals (R. 76–83) is reported at 422 F. 2d 90.

JURISDICTION

The judgment of the court of appeals (R. 84) was entered on February 3, 1970. The Commissioner's timely filed petition for rehearing *en banc* was denied on March 18, 1970 (R. 85). By order dated June 12,

[1] "R." references are to the separately bound record appendix.

1970, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including August 15, 1970. The petition was filed on August 14, 1970, and certiorari was granted on November 9, 1970 (R. 85). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a payment by a savings and loan association to the Federal Savings and Loan Insurance Corporation pursuant to Section 404(d) of the National Housing Act is a nondeductible capital outlay, or is deductible as an ordinary and necessary business expense under Section 162(a) of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 and of the Treasury Regulations on Income Tax (1954 Code) are set forth in Appendix A, *infra*, pp. 41–43. The pertinent provisions of the Federal Home Loan Bank Act and the National Housing Act, before and after their amendment in 1961, are set forth in Appendices B and C, *infra*, pp. 45–56.

STATEMENT

Respondent, a state-chartered (California) savings and loan association, is a member of the Federal Home Loan Bank of San Francisco,[2] and insures its depositors' accounts through the Federal Savings

[2] That bank and other federal home loan banks were established under authority of the Federal Home Loan Bank Act, c. 522, 47 Stat. 727 (12 U.S.C. 1421, *et seq.*).

and Loan Insurance Corporation ("FSLIC").[3] At all relevant times, respondent has been a subsidiary of First Lincoln Financial Corporation, a corporation whose stock is publicly held and traded over the counter. It filed its federal income tax return for 1963, the taxable year here in question, using the cash receipts and disbursements method of accounting.

To maintain depositors' insurance in force, respondent is required to pay to FSLIC regular annual insurance premiums. See Section 404(b) of the National Housing Act (Appendix C, *infra*, p. 51). Such premiums are deductible as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code (Appendix A, *infra*, p. 41). In addition to the "Section 404(b)" payments, respondent is required in certain years to make other payments to FSLIC, described in Section 404(d) of the National Housing Act (Appendix C, *infra*, pp. 52–53) as being "in the nature of * * * prepayment[s] with respect to future premiums." It is the tax character of the "Section 404(d)" payments—whether they are capital expenditures or deductible business expenses—that is here in dispute.

[3] FSLIC, which was created under Title IV of the National Housing Act, c. 847, 48 Stat. 1246 (12 U.S.C. 1724, *et seq.*), operates under the direction of the Federal Home Loan Bank Board. All federal savings and loan associations are required by law to insure their accounts with FSLIC; qualified state-chartered savings and loan associations are permitted to do so. Section 403 of the National Housing Act (12 U.S.C. 1726). Respondent has been a member of FSLIC since 1938 (R. 15, 42).

Section 404(b) payments received by FSLIC are part of its gross income, are available to meet its current expenses and losses, and, to the extent not so used, are transferred to FSLIC's "Primary Reserve." The Primary Reserve, established pursuant to Section 404(a) of the National Housing Act (Appendix C, *infra,* p. 51), is credited annually with FSLIC's net income and thus represents its retained earnings. As such, it is available to meet any losses suffered by FSLIC in future years.

Unlike Section 404(b) payments, Section 404(d) payments are not considered part of FSLIC's regular income but are transferred directly to FSLIC's "Secondary Reserve," as required by Section 404(a). This Reserve is available to FSLIC only to meet its losses and only then to the extent that other available accounts are insufficient to meet such losses. See Section 404(e) of the National Housing Act (Appendix C, *infra,* p. 53). The financial statements of FSLIC reveal no year in which its net insurance losses exceeded even its investment income from the Primary Reserve (R. 20, 40, 59; Ex. 42, p. 17; Ex. 43, pp. 30–31; Ex. 48, p. 17; Ex. 49, p. 19).

An insured savings and loan institution has no interest in FSLIC's Primary Reserve. But it does have a beneficial ownership interest in the Secondary Reserve. That interest is reflected in each institution's separate account maintained by FSLIC (R. 20, 35-36, 52, 57). The amounts in the Secondary Reserve may be withdrawn and used to pay the institution's regular insurance premiums in future years after the total

of the Primary and Secondary Reserves reaches certain levels as explained below. The insured institution's separate account includes a pro rata share of the earnings allocated to the Secondary Reserve "at a rate equal to the average annual rate of return to the Corporation * * * on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States."[4] See Section 404(e).

Under Section 404(b), respondent is required to pay the regular annual premium at the rate of 1/12 of one percent of the total amount of its savings accounts and creditor obligations until such time as FSLIC's Primary Reserve equals two percent of total insured savings accounts and creditor obligations of all insured institutions. Thereafter, additional annual payments are to be made whenever the Primary Reserve falls below the two percent level.[5] Statements for

[4] Not only does FSLIC maintain a separate record of respondent's share of the Secondary Reserve, but it also forwards annual statements to respondent showing, among other things, its current share of the Secondary Reserve and the interest credited to its account during the preceding year (R. 20, 37–38, 52, 57–58). As of December 31, 1967, respondent's pro rata share of the Secondary Reserve amounted to $4,922,115.46 (R. 35, 38, 52). From 1962 through 1967, the rate of return on FSLIC's government securities ranged from 3.15 to 4.23 percent (R. 35–38, 52).

[5] Prior to 1962, annual premiums of 1/12 of one percent of savings accounts and creditor obligations were likewise required, but under the statute then applicable such payments were to be made until FSLIC's general reserve (now the Primary Reserve) equalled or exceeded five percent of insured accounts and creditor obligations of all insured institutions.

the Section 404(b) payments are rendered by FSLIC in the form of "Insurance Premium Notices" (R. 17, 27, 51, 54).

Under Section 404(d), an insured institution must make additional payments in an amount equal to two percent of any net increase in its insured accounts and creditor obligations during the preceding year,[6] reduced by its obligation, if any, as of the end of such year to purchase capital stock in its federal home loan bank. Pursuant to Section 6(c)(1) of the Federal Home Loan Bank Act (12 U.S.C. 1246) (Appendix C, *infra,* p. 49), a member institution in a federal home loan bank must own capital stock in that bank in an amount at least equal to one percent of the member's outstanding unpaid loan principal.[7] FSLIC invoices a Section 404(d) payment by sending a sepa-

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See Section 404(a) of the National Housing Act (Appendix B, *infra*, pp. 46–47). Congress amended Section 404 of Title IV of the National Housing Act (12 U.S.C. 1727) in 1961, effective January 1, 1962. Act of September 8, 1961, P.L. 87-210, 75 Stat. 482.

[6] Prior to the effective date of the amendment of the National Housing Act (see n. 5, *supra*), Congress did not require FSLIC to maintain a Secondary Reserve and there was no provision other than for regular insurance premiums.

[7] Before 1962, the requirement was two percent. In the same act in which Congress amended the National Housing Act (see n. 5, *supra*), it also amended the Federal Home Loan Bank Act, contemplating that the newly imposed Section 404(d) "prepayment requirement would be approximately offset" by the reduction in required outlays for federal home loan bank stock. H. Rep. No. 823, 87th Cong., 1st Sess., p. 2. Respondent has always capitalized its payments for such stock (R. 62).

rate "Notice of Insurance Premium Prepayment" to each insured institution (R. 17, 28–29, 51–52, 54).

When at the close of any calendar year, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions, the obligation of insured institutions to make Section 404(d) payments is suspended until such aggregate amount falls below 1¾ percent of all insured accounts and creditor obligations; the obligation is terminated when the amount in the Primary Reserve alone equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions.[8] In any year in which the obligation to make Section 404(d) payments is suspended, the pro rata share of each insured institution in the Secondary Reserve will be used, to the extent needed and available, to make Section 404(b) payments. Section 404(g) of the National Housing Act (Appendix C, *infra*, pp. 55–56).

According to FSLIC projections made in 1961, the aggregate of the Primary Reserve and the Secondary Reserve would equal or exceed two percent of all insured accounts and creditor obligations of all insured

[8] Section 404 of the National Housing Act was amended by P.L. 91-151, 83 Stat. 371, enacted on December 23, 1969, to provide that only insured accounts (and not creditor obligations) are to be taken into account in determining the required two percent levels in connection with both the suspension and termination of Section 404(d) payments. In the body of this brief we shall refer to Section 404 prior to this amendment unless otherwise noted.

institutions by 1970, and the Primary Reserve itself would reach the two percent level in 1995 (R. 49–51).[9]

Although an insured institution's "right, title or interest" in the Secondary Reserve is not generally transferable or assignable, FSLIC has authority to provide for the transfer of an institution's pro rata share "in cases of merger or consolidation, transfer of bulk assets * * * and similar transactions." Section 404(e).[10] Moreover, an insured institution is entitled to a cash refund of its pro rata share in the event that (1) its status as an insured institution is terminated, (2) a conservator, receiver, or other legal custodian is appointed for the purpose of liquidating the assets of the institution, (3) FSLIC determines that such institution has gone into liquidation, or (4)

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[9] The FSLIC estimates (R. 50) show that Section 404(d) payments would be required to be made from 1962 through 1970, and from 1976 through 1979, and that no such payments would be required from 1971 through 1975, and from 1980 through 1995. Because of the 1969 amendment (n. 8, *supra*), the combined Primary and Secondary Reserves reached the two percent suspension level in 1969, rather than in 1970 as originally projected. Beginning in 1970, the Secondary Reserves are being used to meet the insured institutions' obligations for Section 404(b) payments. Ward, *Taxation: Deductibility of Insurance Premiums by Federal Savings and Loan Associations*, 22 U. Fla. L. Rev. 674, 680. FSLIC has not yet prepared a new projection based on the 1969 amendment, but there is no reason to expect that the new estimates will vary significantly from the previous estimates.

[10] FSLIC has to this time provided by regulation for the automatic transfer of an institution's pro rata share in cases of merger and consolidation. 12 C.F.R. 563.16–2. Other transfers still require FSLIC approval.

the Primary Reserve alone reaches two percent of the total amount of all insured accounts and creditor obligations of all insured institutions. Section 404(f) and (g) of the National Housing Act (Appendix C, *infra*, pp. 54–56).

Pursuant to regulations issued by the California Savings and Loan Commissioner [11] and by the Federal Home Loan Bank Board,[12] respondent reported its interest in FSLIC's Secondary Reserve as an asset on its balance sheets and on its published financial statements, and treated the interest earned on its pro rata share of the Secondary Reserve as income (R. 53).[13] Respondent's parent, although not subject to federal or state accounting regulations, likewise

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[11] Under authority given by Section 8701 of the California Financial Code (30 West Anno. Calif. Code) to establish a uniform classification of accounts for savings and loan associations and to prescribe the manner in which such accounts are to be kept, the California Savings and Loan Commissioner requires that Section 404(d) payments be treated as an asset of a savings and loan association in an account entitled "Contributions to Secondary Reserve—FSLIC"; that the return credited to its pro rata share of the Secondary Reserve be treated as income; and that transfers from such pro rata share to discharge obligations to pay regular annual premiums be treated as expenses (R. 22–23, 31–32, 52–53).

[12] The instructions for the semiannual reports, which each member of the Federal Home Loan Bank System is required to file with the Federal Home Loan Bank Board, require that Section 404(d) payments be listed under "Schedule D, Other Assets" (R. 33–34, 53–54).

[13] Such interest, which is added to respondent's pro rata share of the Secondary Reserve, is not taxed in the year received but in the year in which it is utilized to pay respondent's regular annual insurance premium or paid to respondent in cash. Rev. Rul. 66–49, 1966–1 Cum. Bull. 36.

treated respondent's interest in the Secondary Reserve as an asset on its consolidated financial statements.[14] The firm of Peat, Marwick, Mitchell & Co., certified public accountants, stated in their audits of respondent's financial statements and those of its parent for the years 1962 through 1966 that respondent's financial position and the consolidated financial position had been presented fairly therein, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year (R. 53, 68).

On its federal income tax return for 1963, respondent deducted both its Section 404(b) and Section 404(d) payments as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code (R. 54). The Commissioner allowed the former, but disallowed the latter (R. 55). In a unanimous reviewed opinion (R. 39–75), the Tax Court agreed with the Commissioner. It held that the Section 404(d) payments constituted a nondeductible capital investment in FSLIC, and that such payments could be deducted only when used to pay regular annual insurance premiums or to meet actual losses of FSLIC. A divided court of appeals reversed and held the Sec-

[14] Respondent's parent first become subject to FSLIC's accounting regulations as a result of the enactment on February 14, 1968, of P.L. 90–255, 82 Stat. 5, Sec. 2, which amended Section 408(b)(2) of the National Housing Act. Under the amendment, the parent corporation must file an annual statement with FSLIC.

tion 404(d) payments to be currently deductible business expenses (R. 76–84).

This Court granted the Commissioner's petition for certiorari on November 9, 1970 (R. 85).

INTRODUCTION AND SUMMARY

Section 162(a) of the Internal Revenue Code authorizes a deduction for "ordinary and necessary expenses" that are paid or incurred by a taxpayer during the taxable year in carrying on a trade or business. The quoted phrase has been the subject of elaboration by this Court on numerous occasions. See, *e.g.*, *Welch* v. *Helvering*, 290 U.S. 111; *Helvering* v. *Winmill*, 305 U.S. 79; *Deputy* v. *duPont*, 308 U.S. 488; *Interstate Transit Lines* v. *United States*, 319 U.S. 590; *Commissioner* v. *Tellier*, 383 U.S. 687. As early as the *Welch case, supra* at 113–116, the Court rejected the proposition that the sole criterion of deductibility should be that a payment is "necessary" and held that to obtain a deduction under the predecessor of Section 162(a) the taxpayer must establish that a payment is "ordinary" as well. More recently, in the *Tellier* case, *supra* at 689–690, the Court discussed the term "ordinary" as it appears in Section 162(a) and expressly held that its principal function is to distinguish "between those expenses that are currently deductible and those that are in the nature of capital expenditures * * *." The "necessary" requirement of Section 162(a) is not involved in this case; the only issue is whether respondent's Section 404(d) payments meet the "ordinary" standard as explicated by this Court.

An expenditure is not "ordinary" if it represents the cost of an item in the nature of a capital asset, even if it is forced upon a taxpayer by law or by economic circumstances.[15] There is no dispute between the parties on this point. As respondent put it in its brief in opposition (p. 17), "Compulsion, whether legal or economic, should have no bearing upon the question whether a payment is an expense or a capital expenditure."[16]

The essence of an ordinary business expense is that the benefit from the expense is derived and exhausted

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[15] See *Welch* v. *Helvering*, *supra*; *Woodward* v. *Commissioner*, 397 U.S. 572, 579, n. 8; *Woolrich Woolen Mills* v. *United States*, 289 F. 2d 444, 448 (C.A. 3); *Falstaff Beer, Inc.* v. *Commissioner*, 322 F. 2d 744, 745 (C.A. 5); *Teitelbaum* v. *Commissioner*, 294 F. 2d 541, 544 (C.A. 7), certiorari denied, 368 U.S. 987, and cases cited therein; *Russell Box Co.* v. *Commissioner*, 208 F. 2d 452, 454–455 (C.A. 1); *RKO Theatres, Inc.* v. *United States*, 163 F. Supp. 598 (Ct. Cl.).

[16] In rejecting the government's position that Section 404(d) payments constitute capital outlays, the district court in *Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States*, 304 F. Supp. 1072, 1080 (S.D. Fla.), pointed out that the instant case involves a state-chartered savings and loan association which is not required by law to insure its accounts with FSLIC, while the taxpayer in that case, a federally chartered institution, is required by statute to maintain FSLIC insurance. See n. 3, *supra*. Nothing turns on this distinction which goes only to the "necessary" requirement of Section 162(a). Respondent's Section 404(d) payments were "necessary" in that respondent represents in its advertisements that it is a member of FSLIC, and, in the opinion of its management, termination of coverage would cause a mass withdrawal of savings by depositors (R. 42). *Washington Federal* is now pending on the government's appeals in the Fifth Circuit (Nos. 29,189 and 29,665), and is being held in abeyance with decision to abide the outcome in the instant case.

within the taxable year. In contrast, a cost that "results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year * * *" is a capital outlay. Treasury Regulations on Income Tax (1954 Code), Section 1.461–1(a) (1) and (2) (Appendix A, *infra*, pp. 41–42),[17] See *Wells-Lee* v. *Commissioner*, 360 F. 2d 665 (C.A. 8); *Teitelbaum* v. *Commissioner*, 294 F. 2d 541 (C.A. 7), certiorari denied, 368 U.S. 987; *Darlington-Hartsville Coca-Cola B. Co.* v. *United States*, 273 F. Supp. 229, 231 (D.S.C.), affirmed, 393 F. 2d 494, 496 (C.A. 4), certiorari denied, 393 U.S. 962. Respondent does not question the validity of this fundamental rule of taxation; the sole issue is whether the rule, as applied to the undisputed facts of this case, requires that respondent's Section 404(d) payments be capitalized.

Our position is that respondent's share in the Secondary Reserve, which is evidenced by the annual statements furnished by FSLIC and which earns interest each year based on FSLIC's return on its government securities, constitutes a capital interest in FSLIC. We think it is clear that the benefit of respondent's Section 404(d) payments is not exhausted within the taxable year of payment, but extends far into the future. That benefit is virtually certain to inure to respondent when its share of the Secondary Reserve is used, in accordance with the provisions of

[17] Section 1.446–1(a)(4)(ii) of the Treasury Regulations, which deals specifically with items of plant and equipment, similarly provides that such items "which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account."

Section 404(g) of the National Housing Act, to discharge its obligations for regular annual insurance premiums in future years. If, however, respondent does not recover its share in this manner, it will recover it in some other form in the future.

The sole risk that respondent faces with respect to its share of the Secondary Reserve is that it will be used to discharge FSLIC's obligations to meet its losses. Since FSLIC is required by law to exhaust all of its other resources before turning to the Secondary Reserve, that risk is minimal. In any case, just as the purchase price of stock in a commercial corporation may not be deducted currently simply because of the possibility that the capital it represents may ultimately be used to discharge the corporation's prior obligations, respondent's Section 404(d) payments are not converted from capital into ordinary costs by reason of the risk of loss.

Treatment of the Section 404(d) payments as a capital investment in FSLIC accords with the precedent most nearly in point and with the accounting requirements of the concerned federal and state regulatory authorities. It is, moreover, consistent with the treatment of the payments by respondent's parent, an unregulated corporation, whose financial statements, like respondent's, were certified as being in accordance with generally accepted accounting principles.

Respondent contends that since its liability for Section 404(d) payments is absolute, the annual system of accounting for tax purposes permits a current deduction. There is no merit to this contention. A cost

resulting in the creation of an asset having a useful life extending beyond the close of the taxable year may not be deducted merely because the liability therefor becomes fixed and final during the taxable year. Rather, such a cost must be allocated to the future years in which it produces a benefit, so that the income of all years is correctly reflected.

Likewise without merit is respondent's contention that its Section 404(d) payments are no different than its regular annual insurance premiums and therefore are deductible. This argument simply ignores the fact that while the benefit of respondent's Section 404(b) payments is exhausted within the taxable year of payment as current insurance coverage is provided, respondent retains significant rights in the Secondary Reserve which will provide a benefit in future years. That it cannot be predicted with precision in what future year the benefit of a Section 404(d) payment will be derived is of no significance; it is sufficient for present purposes that the benefit will not be exhausted in the year of payment. Nor is it of moment that respondent cannot easily convert its share of the Secondary Reserve into cash or other liquid assets. The restrictions on the transferability of respondent's share and its inability to control when the benefit from its share will be derived do not alter the fundamental capital character of that interest.

The provisions and legislative history of the National Housing Act and the Federal Home Loan Bank Act reinforce the conclusion that respondent's share of the Secondary Reserve constitutes a capital interest

in FSLIC. Congress amended those statutes in 1961 and first imposed the Section 404(d) payment requirement in order to meet FSLIC's need for additional temporary capital. The Section 404(d) mechanism accomplishes this purpose by requiring member institutions to furnish capital only until such time as FSLIC's Primary Reserve (its retained earnings) is increased to the desired level. Significantly, at the same time, Congress reduced the obligation of savings and loan associations to make permanent capital investments through the purchase of Federal Home Loan Bank stock.

In sum, the court of appeals erroneously allowed as an ordinary and necessary business expense a cost incurred by respondent in acquiring an income-producing capital asset. Its decision is unsound and should be reversed.

ARGUMENT

RESPONDENT'S SECTION 404(d) PAYMENTS CONSTITUTE NONDEDUCTIBLE CAPITAL OUTLAYS

1. SUCH PAYMENTS RESULT IN THE CREATION OF AN ASSET WITH A USEFUL LIFE EXTENDING SUBSTANTIALLY BEYOND THE CLOSE OF THE TAXABLE YEAR

When respondent makes a Section 404(b) payment to FSLIC, that payment becomes part of FSLIC's gross income and respondent has no further interest in it. There is no possibility, remote or otherwise, that respondent will recover the payment, and respondent has no right with respect to the payment other than the right to insurance coverage for the current year. Since, at the end of that year, the benefit to be derived from the payment will have been exhausted, it is proper that respondent deduct the pay-

ment as an ordinary and necessary business expense under Section 162(a).

The situation with respect to a Section 404(d) payment is entirely different. Although respondent must make such a payment, together with the Section 404(b) payment, to maintain current insurance in force, the similarity between the two types of payments ends there. Unlike Section 404(b) payments which ultimately are transferred to FSLIC's Primary Reserve (its retained earnings), Section 404(d) payments go directly into FSLIC's Secondary Reserve and are subject to use by FSLIC only in the unlikely event that they are needed to meet losses after FSLIC has exhausted all of its other funds.[18] In this sense, the Secondary Reserve is truly a capital account, for as the Tax Court observed (R. 66), "what, after all,

[18] Nothing short of a national catastrophe would ever cause FSLIC to use its Secondary Reserve to meet losses. This was apparent in 1962 when the Section 404(d) payment requirement was first imposed. Prior to 1962, FSLIC's lifelong net insurance losses had aggregated only 1.1 percent of its lifelong gross income, and its total expenses only 3.7 percent of such income. (R. 49, 59). The ratio of FSLIC's reserves to its potential liabilities had declined somewhat before 1962 principally because of the retirement of the government's stock in FSLIC. S. Rep. No. 778, 87th Cong., 1st Sess., pp. 2, 12; House Hearings Before Subcommittee on Banking and Currency on H.R. 7108 and H.R. 7109, 87th Cong., 1st Sess., pp. 10, 39. The financial statements of FSLIC reveal no year in which its net insurance losses exceeded even its investment income, much less the annual premiums received each year and the Primary Reserve, both of which would have to be fully consumed before the Secondary Reserve could be utilized (R. 59). Moreover, unlike a private corporation, FSLIC, in the event of catastrophic losses, has a line of credit in the amount of $750,000,000 with the United States Treasury upon which it can draw (Section 402(i) of the National Housing Act (Appendix C, *infra*, pp. 50–51). And, it

is the capital account of any corporation if not a 'Secondary Reserve,' a pool of capital available to creditors in the event that the corporation's current income and retained earnings are not sufficient to satisfy their claims?"

Not only does the Secondary Reserve represent a pool of capital, but respondent has a clear and definite interest in that capital. Effective with the first Section 404(d) payment made by respondent, FSLIC has maintained a separate account showing respondent's pro rata share of the Secondary Reserve, and has forwarded annual statements to respondent evidencing its ownership interest therein (R. 35–38). Moreover, respondent's share of the Secondary Reserve is itself earning a return ranging from 3.15 to 4.23 percent annually (R. 35–38, 52). Under these circumstances, the Tax Court was correct in concluding that respondent's Section 404(d) payments result in the creation of an asset in the form of respondent's interest in the Secondary Reserve.

Pursuant to Section 404(g) of the National Housing Act, respondent's Section 404(d) payments and the income thereon are returnable to respondent at such times (beginning in 1970 and intermittently thereafter) as they are used to discharge its obligations to

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can levy additional assessments upon its members each year not to exceed ⅛ of one percent of the total amount of each member's accounts and creditor obligations. Section 404(c) of the National Housing Act (Appendix C, *infra*, p. 52). The Secondary Reserve becomes available for FSLIC's losses, only if and to the extent that "other accounts of the Corporation [FSLIC] which are available therefor are insufficient for such losses." Section 404(e).

pay ordinary annual insurance premiums.[19] Under FSLIC projections (see n. 9, *supra*), respondent is virtually certain, if it continues in existence, to recover the full value of its pro rata share of the Secondary Reserve in this manner. If, however, full value is not so recovered, respondent's share is returnable to it in cash upon its liquidation, or when the Primary Reserve alone reaches two percent of all insured accounts and creditor obligations of all insured institutions, an event now projected to occur in 1995 (see n. 9, *supra*).[20] And, respondent's interest in the Secondary Reserve is transferable to another association in a consolidation, merger, or bulk sale of its assets. In sum, respondent is incorrect in its assertion (Br. in Opp. 14) that the money it pays into the Secondary Reserve is "[i]n truth and substance * * * gone in the year in which it is paid * * *." Rather, as the undisputed facts of this case show, the benefit of respondent's Section 404(d) payments will inure to it, in one form or another, at a

[19] When, and to the extent so used, respondent would be entitled to an ordinary and necessary business expense deduction.

[20] Respondent claims (Br. in Opp. 3) that no insured institution will ever receive a cash refund of any portion of its share of the Secondary Reserve. This is incorrect. We are advised by FSLIC officials that some insured associations may receive a cash refund of their share of Secondary Reserve when the Primary Reserve reaches the two percent level. For example, if a particular savings and loan association's business grows faster than that of the average savings and loan association while Section 404(d) payments are being made, and grows slower than that of the average savings and loan association while such payments are being used to discharge regular annual insurance premiums, the Primary Reserve could reach the two percent level before that association's pro rata share of the Secondary Reserve is exhausted. The projection tables (R. 49, 50) which show

future time. This, we believe, requires treatment of the payments as capital outlays for tax purposes.

The remote possibility that the Secondary Reserve would be used to meet FSLIC's losses (see n. 18, *supra*) does not change the fact that respondent's interest therein is a capital asset. This risk is, as the Tax Court observed (R. 59), no greater than the risk of loss on any capital investment made by a stockholder in a commercial bank or insurance company. It is probably a good deal less. At all events, the risk does not entitle respondent to a current deduction, for the cost of a capital or depreciable asset may not be deducted at the time of acquisition, even if there is a strong possibility of a loss. See, *e.g.*, *Fall River Gas App. Co.* v. *Commissioner*, 349 F. 2d 515, 516–517 (C.A. 1); *Radio Station WBIR, Inc.* v. *Commissioner*, 31 T.C. 803, 814; *Paxton* v. *Commissioner*, 7 B.T.A. 92; *Lutz* v. *Commissioner* 2 B.T.A. 484.

Wichita State Bank & T. Co. v. *Commissioner*, 69 F.2d 595 (C.A. 5), certiorari denied, 293 U.S. 562, which arose on facts similar to those of this case, supports our position. At issue there was the tax status of contributions made by Texas State Banks to a guaranty fund of up to $5,000,000 for the benefit of depositors. In that case as in this one, each participating bank's pro rata share of the fund was returnable to it upon its withdrawal from the fund or upon its liquidation. The lower court had been persuaded that the contributions were ordinary and necessary business

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that Section 404(d) payments will be fully absorbed into the Primary Reserve are based on average projections for the entire industry.

expenses because they were paid pursuant to a definite liability fixed by law. *Wichita State Bank & Trust Co.* v. *Commissioner,* 27 B.T.A. 822. The court of appeals viewed the matter differently and held (p. 596):

> That fund [the permanent five million dollar guaranty fund] is not intended to be lost or consumed, but is to stand as a reservoir drawn on to provide prompt payment to depositors, but to be at once replenished by the special assessments. It is analogous to the capital of an insurance company. Each bank owns its pro rata part in it, which it ought ultimately to get back. * * * We think the contributions to $5,000,000 Guaranty Fund, while made annually instead of in a lump sum, were essentially capital investments and ought to be dealt with as such. * * *

The same reasoning is applicable here. The Section 404(d) payments made by respondent and others are "not intended to be lost or consumed," but are designed to provide a reservoir of capital until FSLIC's own earnings—its Primary Reserve—increase sufficiently to permit return of that capital to contributors to the fund.

Respondent's own treatment of its Section 404(d) payments also accords with the view that they constitute capital expenditures. Its balance sheets, which were certified by Peat, Marwick and Mitchell as being in accord with generally accepted accounting principles, show such payments as assets and the interest credited thereon as income (R. 53, 68–69). This treatment is in line with the "Uniform Classification of

Accounts" prescribed by the California Savings and Loan Commissioner (R. 22–26, 31–32, 52–53). See also United States Savings and Loan League, *Standard Accounting Manual for Savings and Loan Associations* (1966), p. 113. It is also consistent with the reporting requirements of the Federal Home Loan Bank Board. Respondent's accounting treatment cannot be dismissed as simply a product of regulatory compulsion. Its parent, which was not subject to accounting regulations, treated the assets and income identically in its financial statements, and these statements too were certified by Peat, Marwick and Mitchell.

We recognize, of course, that the federal and state accounting requirements are not conclusive in determining the proper tax treatment of the Section 404(d) payments. See *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 562. However, those requirements are entitled to some weight, *Pennsylvania Power & Light Co.* v. *United States*, 411 F.2d 1300, 1306 (Ct. Cl.), particularly in a case like this one, where, as the Tax Court pointed out (R. 68), the agencies involved would want to be certain that respondent's assets and income were not overstated. Given their concern in this regard, their determination that Section 404(d) payments may not be deducted currently can only be taken as a reflection of the economic fact that respondent's interest in the Secondary Reserve constitutes an income-producing asset generating benefits for future years. It strongly militates against respondent's position that for federal income tax purposes—and only for such purposes—Section 404(d) payments should be treated as currently deductible expenses.

Despite the foregoing considerations, the court below rejected the Tax Court's conclusion that respondent's Section 404(d) payments constitute capital expenditures, and instead followed the contrary decisions of the district courts in *First Federal Savings and Loan Association of St. Joseph* v. *United States*, 288 F. Supp. 477 (W.D. Mo.), appeal dismissed October 14, 1968, and *Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States*, 304 F. Supp. 1072 (S.D. Fla.), pending on the government's appeals in the Fifth Circuit (Nos. 29,189 and 29,665), with decision to abide the outcome in the instant case. Insofar as the question of future benefit is concerned, five central themes seem to underly the decisions adverse to the government's position. The first of these is that since depositors are likely to close their accounts if a savings and loan association cancels its FSLIC insurance, a Section 404(d) payment "has to be made to stay in business" (R. 82). As we have already shown (p. 12, *supra*), and as respondent concedes (Br. in Opp. 17), the fact that a taxpayer's outlay is required by law or coerced by economic circumstances is irrelevant in determining whether the outlay represents an "ordinary" expense or a capital expenditure. Accordingly, we do not deal further with this aspect here.

The other themes stressed by the court below and the district courts are (1) that the demands of the annual system of accounting for tax purposes require treatment of the Section 404(d) payments as ordinary business expenses; (2) that Section 404(d) payments are the same as Section 404(b) payments, the only

difference being that there is a remote possibility of obtaining a return of the former payments; (3) that there is uncertainty as to when such payments may produce a benefit; and (4) that the insured institution has no control over the payments once they are made. But these considerations should not, individually or in combination, alter the conclusion that by making Section 404(d) payments respondent acquired something of value in the nature of a capital asset.

(1) The court of appeals reversed the Tax Court's decision because of what it believed were the demands of "the annual accounting concept of income determination and income tax assessment" (R. 79). This Court has stated that, under this concept, "each 'taxable year' must be treated as a separate unit, and all items of gross income and deduction must be reflected in terms of their posture at the close of such year." *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, 384. See also *Security Mills Co.* v. *Commissioner*, 321 U.S. 281. In reliance on this principle, the Ninth Circuit followed the reasoning of the district court in *First Federal S. & L. Ass'n. of St. Joseph* v. *United States, supra*, 288 F. Supp. at 484–485, and held (R. 79–81) that since respondent's liability for the Section 404(d) payment presently in dispute was fixed and determinable in 1963, and in fact was paid during that year, respondent was entitled to a current deduction for the payment.

We submit that the court below has misunderstood the annual accounting concept. That concept is to be

applied in determining *when* an ordinary and necessary expense may be deducted. See *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516; *United States* v. *Anderson,* 269 U.S. 422. It has no bearing, however, on the question *whether* a particular cost is a deductible expense or a capital expenditure.[21] If a cost results in the creation of an asset having a useful life extending beyond the close of the year, the cost must be capitalized even if the taxpayer's liability is fixed before the end of the year, and even if payment is made within the year. See, *e.g., First National Bank in Wichita* v. *Commissioner,* 46 F. 2d 283 (C.A. 10); *Lots, Inc.* v. *Commissioner,* 49 T.C. 541, 550–551, affirmed on another issue, *sub nom. Christie* v. *Commissioner,* 410 F. 2d 759 (C.A. 5); *Paxton* v. *Commissioner,* 7 B.T.A.

[21] In Rev. Rul. 66–49, 1966–1 Cum. Bull. 36, the Internal Revenue Service ruled that Section 404(d) payments are not deductible when paid. Cf. Treasury Regulations on Income Tax (1954 Code), Section 1.162–13. It also ruled that the return on such payments is not taxable when credited but only when it is used to discharge a savings and loan association's obligation to pay regular annual insurance premiums, or when otherwise made available to the association without substantial restriction or limitation. As the Tax Court held (R. 70, n. 10), there is no inconsistency between these rulings. The question when the return is to be taken into income turns on the application of the doctrine of actual or constructive receipt in the case of a cash basis taxpayer, and, in the case of an accrual basis taxpayer, on whether all events have occurred to fix the taxpayer's right to the income. The question posed in this case—whether respondent's Section 404(d) payments are capital expenditures or deductible business expenses—depends, as we have said, on the wholly different issue whether the payments will provide a benefit in future years.

92; *Lutz* v. *Commissioner,* 2 B.T.A. 484.[22] That is the nature of a capital expenditure.

In its discussion of tax accounting principles, the majority of the court of appeals apparently proceeded on the assumption that respondent's Section 404(d) payments are a "recurring annual expense" (R. 82). This is incorrect as pointed out in the dissenting opinion (R. 83). Based on FSLIC's 1961 projections (R. 50), such payments would be required to be made in only 13 of the 34 years between 1962 and 1995 (see n. 9, *supra*). It is respondent's regular insurance premiums (its Section 404(b) payments), not its Section 404(d) payments, that are its "recurring annual expense." In attempting to justify its holding as somehow matching respondent's costs and revenues in accordance with tax accounting principles, the Ninth Circuit has formulated a rule that has exactly the opposite effect. For, under its decision, there

[22] In Section 461(f) of the Code, Congress carved out an exception to the general rule that an accrual basis taxpayer may not take a deduction until its liability for payment is finally determined. Under this provision, payments for liabilities may be deducted even though they are contested and thus are not final. The court of appeals inferred (R. 81–82) that since Congress has allowed a deduction for a contested liability where payment is made, the fact of payment is somehow relevant in characterizing a cost as an expense or a capital expenditure. No such inference is permissible. Section 461(f) itself provides that a deduction is allowable thereunder only if, *inter alia*, "but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer [of funds] (or for an earlier taxable year) * * *." Thus, a contested capital expenditure (as on a contract to build a new building) would not be deductible under Section 461(f), even though it was paid while the contest was pending.

would be some years in which savings and loan associations would receive two deductions, and others in which they would be entitled to no deduction at all, even though they would have the benefit of FSLIC insurance in all taxable years.

Proper tax accounting principles require that Section 404(d) payments be deducted only as they are used to discharge respondent's obligations for regular annual insurance premiums. Only in this manner will the costs of FSLIC insurance be matched against the revenues generated because such insurance is maintained. The very purpose of the regulatory rule requiring the capitalization of costs which provide a benefit extending beyond the close of the taxable year is to prevent the distortion of income that would occur if the costs relating to the income of a number of years were charged off against the income of a single year.[23] See *United States* v. *Ludey,* 274 U.S. 295, 300–301. That purpose would be thwarted if respondent is permitted to deduct its Section 404(d) payments in the years in which such payments are made.

[23] Rev. Rul. 69–382, 1969–2 Cum. Bull. 28, is fully consistent with this purpose. That ruling is applicable to employers who, as part of their current annual labor costs, must pay accident and health insurance premiums to provide deferred, as well as present coverage, for groups of employees, generally under labor contracts. The ruling permits a full deduction of those premiums if the portion not applied during the current year is no more than may be expected to be applied in providing retired life coverage in future years. The theory underlying the ruling is that since the full benefit of the employees' services is realized during the current year, the full cost of those services should be deducted during that year.

(2) It is true, to be sure, that both the Primary and Secondary Reserves of FSLIC are available to meet its future losses. But, to conclude from this that the Section 404(b) payments, which go into the Primary Reserve, and the Section 404(d) payments, which go into the Secondary Reserve, are the same is to ignore the significant differences between these Reserves and the very substantial rights that a savings and loan association enjoys with respect to the Secondary Reserve.

To the extent that the decision below is premised on the assumption that there is only a remote possibility that respondent will receive a future benefit from its Section 404(d) payments, we believe it is factually in error. As we have shown (see n. 18, *supra*), the Secondary Reserve will be used to meet FSLIC's losses, rather than to provide respondent a future benefit, only in the unlikely event of a total national catastrophe.[24] Indeed, respondent and other savings and loan associations have already begun to benefit from their prior Section 404(d) payments, for these payments are now being used to discharge their obligations for regular annual insurance premiums.

[24] As the Tax Court pointed out (R. 70), cases holding that an otherwise deductible payment is not rendered nondeductible merely because of a contingent possibility of recovery (see, *e.g.*, *Mel Dar Corp.* v. *Commissioner*, 309 F. 2d 525 (C.A. 9); *Burnet* v. *Hutchinson Coal Co.*, 64 F. 2d 275 (C.A. 4); *George K. Herman Chevrolet, Inc.* v. *Commissioner*, 39 T.C. 846; and *Electric Tachometer Corp.* v. *Commissioner*, 37 T.C. 158) are not relevant here. The principle of those cases applies only where the expenditure is conceded or determined to be an "ordinary" business expense.

Respondent's interest in the Secondary Reserve cannot properly be characterized as a deductible expense merely because its purpose in making Section 404(d) payments—to maintain FSLIC insurance in force—and the consequence of failing to make such payments—loss of such insurance— are the same as the purpose of making Section 404(b) payments and the consequence of not making those payments. With regard to both types of payments, respondent is seeking to insure the continuation and growth of its business, just as a manufacturing concern must purchase machinery and pay salaries to employees to continue its business and provide for its growth. The fact that such a concern's purpose in purchasing machinery and paying salaries is the same does not justify deduction of the cost of the machinery as an ordinary and necessary business expense. The identity of purpose in this case similarly does not justify deduction of respondent's Section 404(d) payments.[25]

[25] Respondent is not helped by holdings purporting to apply the rationale of *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, and permitting ordinary loss deductions on the sale or exchange of capital assets when purchased as an interim step in the acquisition of a temporary source of supply. See *Booth Newspapers, Inc.* v. *United States*, 303 F. 2d 916 (Ct. Cl.). See also *Smith & Welton* v. *United States*, 164 F. Supp. 605 (E.D. Va.); *Commissioner* v. *Bagley & Sewall Co.*, 221 F. 2d 944 (C.A. 2); *Western Wine & Liquor Co.* v. *Commissioner*, 18 T.C. 1090. Apart from considerations of whether such ordinary loss treatment serves the intendment of *Corn Products*, the *Corn Products* question is not reached in the instant case because respondent has neither sold nor exchanged its interest in the Secondary Reserve. Respondent argued below that capital contributions to the Federal National Mortgage Association are

(3) Any uncertainty as to the precise future time when a Section 404(d) payment will produce a benefit likewise does not affect the character of the payment. In differentiating between current expenses and capital expenditures, the critical question is whether the benefit of the cost will be exhausted in the current year or will extend substantially beyond the close of that year. At the end of any taxable year in which respondent makes a Section 404(d) payment, there is no uncertainty regarding the answer to this question. For example, at the end of 1963, the year here in issue, it was known with absolute certainty that the benefit from the Section 404(d) payment made by respondent during that year had not been exhausted or even impaired, but would be derived in full in a subsequent year. The remote possibility of consumption of the payment that had existed during the year was by the end of the year eliminated.[26] No more is

deductible as ordinary business expenses and urged that the same treatment must be afforded its interest in the Secondary Reserve. Respondent failed to note that those deductions resulted from losses on exchanges of mortgages for FNMA stock. See *McMillian Mortgage Co.* v. *Commissioner*, 36 T.C. 924. More importantly, such deductions are now permitted only by virtue of a special provision of the 1954 Code (Section 162 (d) (Sec. 8(a), Act of September 14, 1960, P.L. 86-779, 74 Stat. 998), effective December 31, 1959 (Sec. 8(d)), specifically limited to FNMA stock purchases, and excepting them from the general rule applicable to capital investments.

[26] In support of the decision below, respondent cited (Br. in Opp. 11) I.T. 2764, XIII-1 Cum. Bull. 45, and Rev. Rul. 62, 1953-1 Cum. Bull. 71, where the Internal Revenue Service ruled that a payment made by a commercial bank to the Federal Deposit Insurance Corporation (FDIC) for insurance is currently deductible even though, if the payment proves excessive based

necessary to require respondent to capitalize the payment. The fact that there is some uncertainty as to which future year the payment will benefit emphasizes the capital nature of the payment, and does not justify deduction of the payment in the year in which it is made.[27]

(4) Nor is a current deduction justified because, given respondent's need to continue FSLIC insurance in force, it does not have it within its power to recover its Section 404(d) payments whenever it wishes to do so—in other words, because the payments are not mere deposits. The payments are subject to the remote possibility of use by FSLIC to meet its losses; respondent's interest in the Secondary Reserve can be transferred only in accordance with FSLIC regula-

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on FDIC's income for the year of payment, the excess portion will be credited against the succeeding year's payment. These rulings are not in point. The credit given an insured commercial bank toward its next year's premium is little more than a method of refunding an excessive current premium. If the FDIC were able to determine at the end of the year the precise amounts of its expenses and losses, such a mechanism would be unnecessary because the adjustment could be made within the year. The Section 404(d) payments here in question are not comparable to the FDIC insurance premiums.

[27] The observation of the district court in *Washington Fed. S&L. Ass'n of Miami Beach* v. *United States*, *supra*, 304 F. Supp. at 1076, that it is "in the realm of pure speculation" whether and when a Section 404(d) payment will result in a benefit is incorrect. That there will be a future benefit is almost certain. Even if it were totally uncertain as to when, in the future, the benefit would be derived, a current deduction would not be allowable. However, the uncertainty is not as great as the district court suggested. FSLIC's estimates of the buildup of the Primary and Secondary Reserves have been quite accurate. See n. 9, *supra*.

tions or upon approval by FSLIC; and respondent will recover the payments in the normal course when the aggregate of the Primary and Secondary Reserves reaches the two percent level specified in Section 404 (g) of the National Housing Act, an event admittedly beyond respondent's power to control. But it does not follow because respondent's interest in the Secondary Reserve can be liquidated only in stated circumstances, that its Section 404(d) payments are ordinary business expenses, rather than capital expenditures. Contrary to the assumption implicit in the control argument, a capital cost is not converted into a deductible expense merely because the cost may not easily be recovered through immediate conversion into cash or other assets. See, *e.g., Connecticut Light and Power Co.* v. *United States,* 368 F. 2d 233, 241–242 (Ct. Cl.); *Robertson* v. *Steele's Mill,* 172 F. 2d 817 (C.A. 4); *Gauley Mt. Coal Co.* v. *Commissioner,* 23 F. 2d 574, 578 (C.A. 4); *J. C. Cornillie Co.* v. *United States,* 298 F. Supp. 887, 896–897 (E.D. Mich.); *Lutz* v. *Commissioner,* 2 B.T.A. 484.[28]

[28] In *Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States*, *supra*, 304 F. Supp. at 1078, the district court relied on the Eighth Circuit's decision in *United States* v. *Weber Paper Co.*, 320 F. 2d 199, as authority for the proposition that control is to be taken into account in characterizing a cost as a deductible expense or a capital expenditure. Apart from the fact that we do not agree with that decision (Rev. Rul. 64–72, 1964–1 Cum. Bull. (Part 1) 85), we do not think that the case can properly be so read, since the government did not contend that the premium payments there in issue were capital expenditures. Rather, the government's argument was that even though the payments were ordinary and necessary business expenses, they were not paid or incurred during the

Respondent argues (Br. in Opp. n. 2) that, by reason of the absence of control, its Secondary Reserve interest is "illusory." There is nothing illusory, however, about either the benefit respondent is presently receiving because a portion of its share of the Secondary Reserve is being used to discharge its current Section 404(b) obligation—with a corresponding deduction for the payment of that obligation—or the return respondent is earning on its share of the Secondary Reserve, which itself is added to respondent's interest therein. The restrictions and limitations to which respondent's Secondary Reserve interest is subject and the postponement of the beneficial enjoyment of the income do not affect the capital character of that interest. They suggest only that the interest is not as desirable a capital asset as it otherwise might be.[29]

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taxable year because of the taxpayer's retention of control. Any suggestion that the Eighth Circuit has adopted the control test is dispelled by its recent opinion in *M.F.A. Central Cooperative* v. *Bookwalter*, 427 F. 2d 1343, petition for a writ of certiorari pending, No. 824, this Term. In that case, the court held that Class C stock purchased by the taxpayer in a Bank for Cooperatives was a capital asset, despite restrictions on alienability comparable to those in the instant case.

[29] The district court in *Washington Fed. S. & L. Ass'n* v. *United States*, *supra*, distinguished *Wichita State Bank & T. Co.* v. *Commissioner*, 69 F. 2d 595 (C.A. 5), certiorari denied, 293 U.S. 562, on which we rely (see pp. 20–21, *supra*). It pointed out (304 F. Supp. at 1078–1079) that the taxpayer in that case, unlike respondent, had the choice either to insure depositors' accounts through the guaranty fund or to take out a bond, and therefore could withdraw its deposit at any time. While this is a factual distinction between the cases, nothing in the Fifth Circuit's opinion suggests that it was relevant to the court's decision that the payments to the guaranty fund constituted capital expenditures.

2. THE PROVISIONS AND BACKGROUND OF THE NATIONAL HOUSING ACT AND THE FEDERAL HOME LOAN BANK ACT SHOW THAT RESPONDENT'S INTEREST IN THE SECONDARY RESERVE IS A CAPITAL INTEREST

At the outset of its opinion (R. 55–56), the Tax Court stated that the issue presented here should not be decided by the description of a Section 404(d) payment in the National Housing Act—"an additional premium in the nature of a prepayment with respect to future premiums." It recognized (*ibid.*) that if this description were controlling, Section 404(d) payments would be treated as prepaid insurance premiums and would not be deductible in the year of payment.[30] But the court preferred to rest its decision on the nature and substance of what was acquired, rather than the label provided by a non-tax statute.[31] It accordingly made a detailed analysis of the provisions and background of the National Housing Act and the Federal Home Loan Bank Act. Consistently with this approach, it rejected respondent's contention that since Congress used the nomenclature of the insurance industry in the National Housing Act, and

[30] See, *e.g.*, *Commissioner* v. *Boylston Assn.*, 131 F. 2d 966 (C.A. 1); *Higgenbottom-Bailey-Logan Co.* v. *Commissioner*, 8 B.T.A. 566, 577; *Peters* v. *Commissioner*, 4 T.C. 1236, 1242. Although the rationale of *Waldheim Realty & Inv. Co.* v. *Commissioner*, 245 F. 2d 823 (C.A. 8), is arguably to the contrary, the holding there involved a situation where the taxpayer had, for more than forty years, treated prepaid insurance as an expense on its books.

[31] We note that although the Tax Court took care to differentiate between a prepaid insurance premium and a capital asset, a current deduction is denied for both on the same theory—that the cost incurred will provide a benefit in subsequent taxable years.

specifically provided for the buildup of "reserves," the Section 404(d) payments, which are added to the Secondary Reserve, must be treated as insurance premiums (R. 65).

Looking to the nature and substance of what was acquired, as the Tax Court did, respondent's Section 404(d) payments cannot be dismissed as "nothing more than an increase in the amount of the regular premiums" (*Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States, supra,* 304 F. Supp. at 1076). If Congress had been concerned that the ordinary insurance premiums payable under Section 404(b) were not adequate to provide insurance coverage or protect bank depositors, it could simply have increased the ordinary premiums when it amended the National Housing Act in 1961. See nn. 5, 18, *supra.* However, the ordinary insurance premiums were more than adequate. Prior to 1962, when the Section 404(d) payment requirement was first imposed, FSLIC's net insurance losses had aggregated only 1.1 percent of its gross income, and total expenses only 3.7 percent of such income (R. 49, 59). Congress was aware of these facts in 1961 and of the fact that FSLIC's losses had never exceeded even its investment income for any year (R. 65). Under these circumstances, it saw no need to increase ordinary insurance premiums and did not do so.

Congress also knew in 1961 that the ratio of FSLIC's reserves to its potential liabilities had declined somewhat because of the retirement of the government's stock in FSLIC. S. Rep. No. 778, 87th

Cong., 1st Sess., pp. 2, 12; H. Hearings Before Subcommittee on Banking and Currency on H.R. 7108 and H.R. 7109, 87th Cong., 1st Sess., pp. 10, 39. It was concerned with this loss of capital and was faced with the problem of raising capital to replace it. Accordingly, as the Tax Court explained (R. 65), Congress set out to create a temporary pool of capital "which would serve as a buffer until the FSLIC had accumulated enough of its own income to bring its 'Primary Reserves,' the true insurance reserve, to the desired two percent level."

Finding that the capital represented by the insured associations' investments in Federal Home Loan Bank (FHLB) stock was more than adequate to cover existing mortgage obligations (see Hearings, *supra* at 9), Congress devised a plan whereby capital that would otherwise have been furnished FHLB for its stock would instead be channelled to FSLIC. It provided for Section 404(d) payments and at the same time lowered the FHLB stock purchase requirement from two percent to one percent of an association's aggregate unpaid loan principal. In doing so, it explained that for most member institutions the Section 404(d) "prepayment requirement would be approximately offset" by the resulting reduction in outlays for FHLB stock which members previously had been required to make. H. Rep. No. 823, 87th Cong., 1st Sess., p. 2; S. Rep. No. 778, 87th Cong., 1st Sess., pp. 1–2.[32]

[32] In addition, Congress provided that instead of collecting regular insurance payments under Section 404(b) until such time as FSLIC's Primary Reserve equalled or exceeded five percent of its potential liabilities, such payments would cease when the Reserve reached two percent of total insured savings

The action taken by Congress in establishing the Secondary Reserve thus was more than a "mechanical vehicle" for identifying unused additional ordinary premiums (*Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States, supra,* 304 F. Supp. at 1076). Rather, it amounted to a new evaluation of the amounts which member institutions would be required to *spend* (the ordinary insurance premiums), to invest *permanently* (FHLB stock in the amount of one percent of aggregate unpaid loan principal), and to invest *temporarily* (the Section 404(d) payments). As the Tax Court observed (R. 64, 66–67), no sharp line of distinction can be drawn between the FHLB capitalization and the FSLIC Secondary Reserve. In contrast to the ordinary premiums designed to meet ordinary insurance costs and forever lost to member institutions in the year of payment, the payments placed in the Secondary Reserve and the amounts used to purchase FHLB stock represent investments in a special pool of capital which is maintained to afford depositors additional protection against losses of an extraordinary nature (R. 63–64).

If the similarities in their capital natures were otherwise debatable, further dispute is laid to rest by the provision that when a member institution is required to purchase additional FHLB stock (to stay abreast of the one percent requirement), its Section 404(d) payment is reduced by that amount. This credit is not theoretical. In 1964, respondent's Section

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and creditor obligations of member institutions, and would not thereafter be required unless and until the Reserve fell below the two percent level.

404(d) payment would have been $1,234,929, except that an FHLB stock purchase credit of $784,100 reduced the required payment to FSLIC to $450,829 (R. 29). The Tax Court therefore was fully justified in its view (R. 67) as to the "fungibility" of FHLB stock payments and Section 404(d) payments and in its conclusion that respondent's interest in the Secondary Reserve, like its FHLB stock, constitutes a capital investment.[33]

The statutes and legislative history focus upon the role of Section 404(d) payments as part of the capital structure of FSLIC. The court below thought (R. 78-79) that the Tax Court gave excessive weight to the treatment of the payments by FSLIC as compared with the weight given to the payments from the standpoint of the institutions making them. We do not agree. To the extent that the legislative evidence casts light upon the nature of FSLIC's Secondary Reserve, it is as relevant as any other evidence in determining what respondent acquired when it made Section 404(d) payments.[34] In concluding to the contrary, the court below erroneously discounted strong evidence of legislative intent which reinforces the conclusion that the outlays in question represent capital expenditures.

[33] During the 30 years it has purchased FHLB stock, respondent has always treated such outlays as capital expenditures (R. 62).

[34] The converse of this Court's statement in *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, 27, that "[i]f they are capital investments to one they are capital sales to the other" would seem to be true in the instant case.

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

* * * * *

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.461–1. *General rule for taxable year of deduction.*

(a) *General rule*—(1) *Taxpayer using cash receipts and disbursements method.* Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis

shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) *Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461–2. Where

a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

* * * * *

APPENDIX B

Federal Home Loan Bank Act, c. 522, 47 Stat. 727:

SEC. 6. [as amended by Sec. 509 of the National Housing Act, c. 847, 48 Stat. 1264, and Sec. 2 of the Act of June 27, 1950, c. 369, 64 Stat. 257, 12 U.S.C. (1958 ed.) 1426].

* * * * *

(c) The original stock subscription for each institution eligible to become a member under section 4 shall be an amount equal to 1 per centum of the aggregate of the unpaid principal of the subscriber's home mortgage loans, but not less than $500. The board shall from time to time adjust the amount of stock held by each member so that, as nearly as possible, such member shall at all times have invested in the stock of the Federal Home Loan Bank at least an amount calculated in the manner provided in the preceding sentence (but not less than $500). If the board finds that the investment of any member in stock is greater than that required under this section, upon application of such member, the bank shall pay such member for each share of stock in excess of the amount so required an amount equal to the value of such stock, or, at the election of the bank, the whole or any part of the payments which would be so made shall be credited upon the indebtedness of the member to the bank. In either such event, stock equal in value to the amount of the payment or credit, or both, as the case may be, shall be surrendered and canceled. No share of stock shall be surrendered and canceled if the effect of such surrender and cancellation would be to violate the provisions of section

10(c) requiring the amount of stock held by such member to equal at least one-twelfth of the outstanding advances to such member.

* * * * *

(l) Within one year after the enactment of this subsection, each member of each Federal Home Loan Bank shall acquire and hold and thereafter maintain its stock holding in an amount equal to at least 2 per centum of the aggregate of the unpaid principal of such member's home mortgage loans, home-purchase contracts, and similar obligations, but not less than $500. Such stock in excess of the amount hereby required may be purchased from time to time by members and may be retired from time to time as heretofore. One year after the enactment of this subsection, each Federal Home Loan Bank shall retire and pay off at par an amount of its stock held by the Secretary of the Treasury equivalent to the amount of its stock held by its members in excess of the amount required to be held by them by the first two sentences of subsection (c) of this section immediately prior to the enactment of this subsection and annually thereafter each Federal Home Loan Bank shall retire an amount of such Government stock equivalent to 50 per centum of the net increase of its stock held by members since the last previous retirement: *Provided*, That none of such Government capital shall at any time be retired so as to reduce the aggregate capital stock, reserves, surplus, and undivided profits of the Federal Home Loan Banks to less than $200,000,000: *Provided further*, That notwithstanding any provision of this subsection, nothing in this subsection shall limit or affect the operation of subsection (g) of this section.

National Housing Act, c. 847, 48 Stat. 1246:

SEC. 404 [as amended by Sec. 25, Act of May 28, 1935, c. 150, 49 Stat. 298, and Sec. 7 of the

Act of June 27, 1950, 64 Stat. 259, 12 U.S.C. (1958 ed.) 1727].

(a) Each institution whose application for insurance is approved by the Corporation shall pay to the Corporation, in such manner as it shall prescribe, a premium charge for such insurance equal to one-twelfth of 1 per centum of the total amount of all accounts of the insured members of such institution plus any creditor obligations of such institution. Such premium shall be paid at the time the certificate is issued by the Corporation under section 403, and thereafter annually until a reserve fund has been established by the Corporation equal to 5 per centum of all insured accounts and creditor obligations of all insured institutions; except that under regulations prescribed by the Corporation such premium charge may be paid semiannually. If at any time such reserve fund falls below such 5 per centum, the payment of such annual premium charge for insurance shall be resumed and shall be continued until the reserve is brought back to such 5 per centum. For the purposes of this subsection, the amount in all accounts of insured members and the amount of creditor obligations of any institution may be determined from adjusted statements made within one year prior to the approval of the application of such institution for insurance, or in such other manner as the Corporation may by rules and regulations prescribed.

(b) The Corporation is further authorized to assess against each insured institution additional premiums for insurance until the amount of such premiums equals the amount of all losses and expenses of the Corporation; except that the total amount so assessed in any one year against any such institution shall not exceed one-twelfth of 1 per centum of the total amount of the accounts of its insured members and its creditor obligations.

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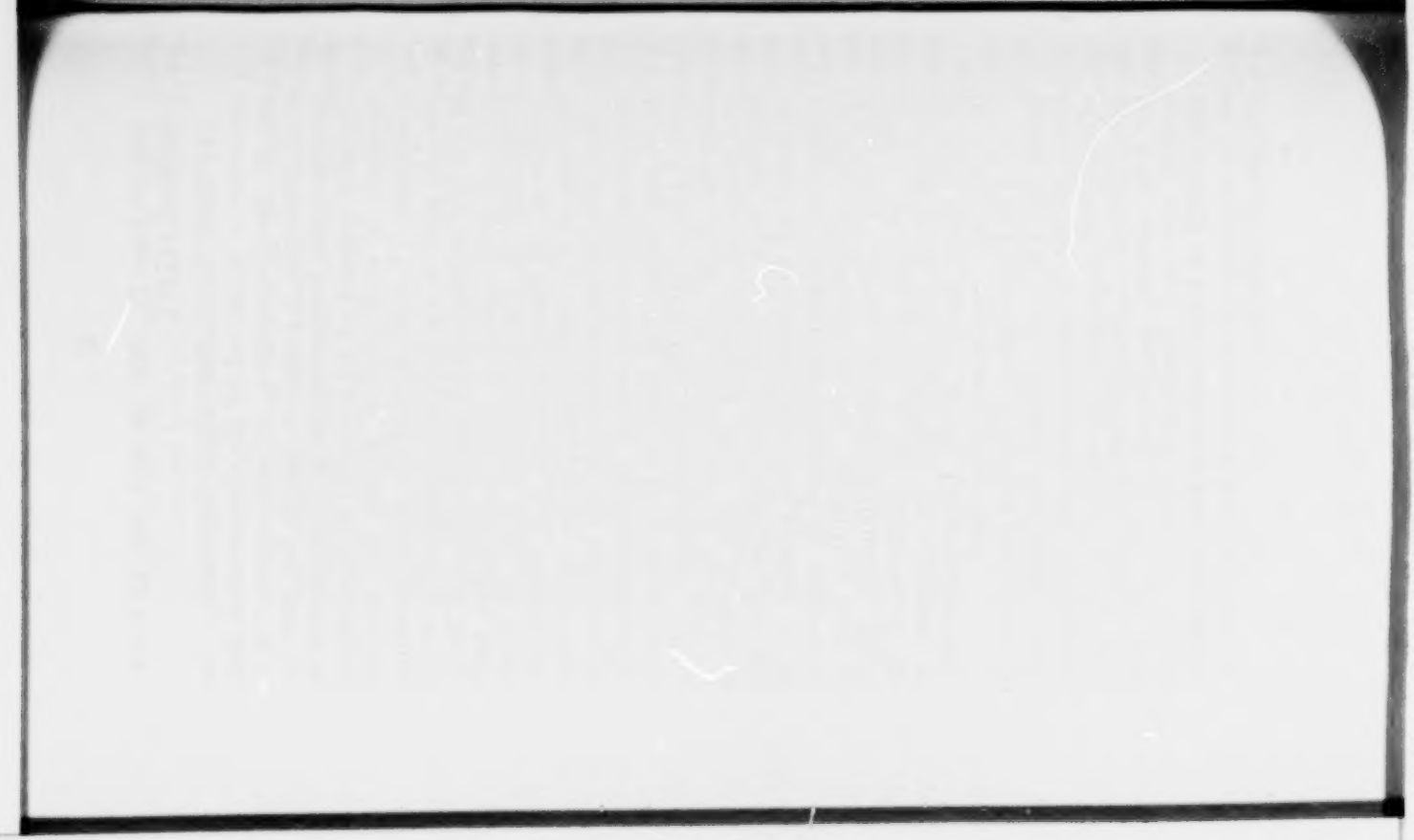

APPENDIX C

Federal Home Loan Bank Act, c. 522, 47 Stat. 727:

SEC. 6. [as amended by Sec. 1 of the Act of September 8, 1961, P.L. 87–210, 75 Stat. 482, 12 U.S.C. 1426].

* * * * *

(c)(1) The original stock subscription of each institution eligible to become a member under section 4 shall be an amount equal to 1 per centum of the subscriber's aggregate unpaid loan principal, but not less than $500. The bank shall annually, as of the close of the calendar year, adjust, at such time and in such manner and upon such terms and conditions as the Federal Home Loan Bank Board may by regulations or otherwise prescribe, the amount of stock held by each member so that such member shall have invested in the stock of the Federal Home Loan Bank at least an amount calculated in the manner provided in the next preceding sentence (but not less than $500). If the bank finds that the investment of any member in stock is greater than that required under this subsection it may, unless prohibited by said Board or by the provisions of paragraph (2) of this subsection, in its discretion and upon application of such member retire the stock of such member in excess of the amount so required. Said Board, in its discretion, may, by regulations or otherwise, provide for adjustments in amounts of stock to be issued or retired in order that stock may be issued or retired only in entire shares.

* * * * *

National Housing Act, c. 847, 48 Stat. 1246:

SEC. 402. [as amended by Sec. 6 of the Act of June 27, 1950, c. 369, 64 Stat. 259, 12 U.S.C. 1725].

* * * * *

(i) The Corporation is authorized to borrow from the Treasury, and the Secretary of the Treasury is authorized and directed to loan to the Corporation on such terms as may be fixed by the Corporation and the Secretary, such funds as in the judgment of the Home Loan Bank Board are from time to time required for insurance purposes, not exceeding in the aggregate $750,000,000 outstanding at any one time, and the Corporation hereafter shall not exercise its borrowing power under the first sentence of subsection (d) of this section for the purpose of borrowing money from any other source: *Provided,* That each such loan shall bear interest at a rate determined by the Secretary of the Treasury, taking into consideration the current average rate on outstanding marketable obligations of the United States as of the last day of the month preceding the making of such loan: *Provided further,* That nothing in this subsection shall prevent the Corporation from issuing debentures in accordance with the provisions of subsection (b) of section 405. For the purposes of this subsection the Secretary of the Treasury is authorized to use as a public-debt transaction the proceeds of the sale of any securities hereafter issued under the Second Liberty Bond Act, as now or hereafter in force, and the purposes for which securities may be issued under the Second Liberty Bond Act, as now or hereafter in force, are hereby extended to include such loans. Any such loan shall be used by the Corporation solely in carrying out its functions with respect to such insurance. All loans and repayments

under this subsection shall be treated as public-debt transactions of the United States.

SEC. 404. [as amended by Secs. 3, 4, 5, and 6 of the Act of September 8, 1961, *supra*, 12 U.S.C. 1727].

(a) The Corporation shall establish a Primary Reserve which shall be the general reserve of the Corporation and a Secondary Reserve to which shall be credited the amounts of the prepayments made by insured institutions pursuant to subsection (d) and the credits made pursuant to the first sentence of subsection (e).

(b)(1) Each institution whose application for insurance is approved by the Corporation shall pay to the Corporation, in such manner as it shall prescribe, a premium for such insurance equal to one-twelfth of 1 per centum of the total amount of all accounts of the insured members of such institution plus any creditor obligations of such institution. Such premium shall be paid at the time the certificate is issued by the Corporation under section 403, and thereafter annually, except that under regulations prescribed by the Corporation such premium may be paid semiannually.

(2) If, at the close of any December 31, the Primary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions as of such close, no premium under paragraph (1) of this subsection shall be payable by any insured institution with respect to its premium year beginning during the year commencing on May 1 next succeeding such December 31, except that the foregoing provisions of this sentence shall not be applicable to any insured institution with respect to any of the twenty premium years beginning with the premium year commencing with the date on which such certificate is issued.

(3) The Corporation is authorized to pre-

scribe such rules and regulations as it may determine to be necessary or appropriate to accomplish the purposes and provisions of this subsection.

(c) The Corporation is further authorized to assess against each insured institution additional premiums for insurance until the amount of such premiums equals the amount of all losses and expenses of the Corporation; except that the total amount so assessed in any one year against any such institution shall not exceed one-eighth of 1 per centum of the total amount of the accounts of its insured members and its creditor obligations.

(d) Each insured institution, except as otherwise provided in this section, shall annually pay to the Corporation, at such time and in such manner as the Corporation shall by regulations or otherwise prescribe, an additional premium in the nature of a prepayment with respect to future premiums of such institution under subsection (b) equal to 2 per centum of the net increase in all accounts of its insured members during the next preceding calendar year, less an amount equal to any requirement, as of the end of such calendar year, for the purchase of stock of the Federal Home Loan Bank of which such institution is a member, calculated in accordance with the provisions of subsection (c) of section 6 of the Federal Home Loan Bank Act and without regard to any net increase during such calendar year in its holdings of such stock, and such prepayments shall be credited to the Secondary Reserve: *Provided*, That in the case of an insured institution which was not an insured institution at the beginning of such next preceding calendar year the 2 per centum aforesaid shall be 2 per centum of the net increase in all accounts of its insured members during that part of said calendar year which begins with the close of the day on which

such institution becomes an insured institution and the amount deducted from such 2 per centum under the foregoing provisions of this sentence shall not exceed one-half of such 2 per centum as calculated in accordance with this proviso. The Federal Home Loan Bank Board shall by regulations or otherwise provide for the furnishing to the Corporation of all necessary information with respect to Federal Home Loan Bank stock.

(e) The Corporation, in accordance with such regulations as it may prescribe, shall credit to the Secondary Reserve, as of the close of each calendar year a return on the outstanding balances of the Secondary Reserve during such calendar year, as determined by the Corporation, at a rate equal to the average annual rate of return to the Corporation during the year ending at the close of November 30 of such calendar year, as determined by the Corporation, on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States. Except as provided in subsections (f) and (g), the Secondary Reserve shall be available to the Corporation only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses. No right title, or interest of any institution in or with respect to its pro rata share of the Secondary Reserve shall be assignable or transferable, whether by operation of law or otherwise, except to such extent as the Corporation may by regulation or otherwise provide for transfer of such pro rata share in cases of merger or consolidation, transfer of bulk assets as defined by the Corporation by regulation or otherwise for the purposes of this sentence, and similar transactions as so defined.

(f) If (i) the status of an insured institution as an insured institution is terminated pursuant

to any provision of section 407 or the insurance of accounts of an insured institution is otherwise terminated, (ii) a conservator, receiver, or other legal custodian is appointed for an insured institution under the circumstances and for the purpose set forth in subdivision (d) of section 401, or (iii) the Corporation makes a determination that for the purposes of this subsection an insured institution has gone into liquidation, the obligation of such institution to make prepayments under subsection (d) of this section, including any prepayments as to which such institution is obligated at the time of such termination, appointment, or determination, shall cease, and the Corporation shall pay in cash to such institution its pro rata share of the Secondary Reserve, in accordance with such terms and conditions as the Corporation may prescribe by regulations or otherwise, or, at the option of the Corporation, the Corporation may apply the whole or any part of the amount which would otherwise be paid in cash toward the payment of any indebtedness or obligation, whether matured or not, of such institution to the Corporation, then existing or arising before such payment in cash: *Provided,* That such payment or such application need not be made to the extent that the provisions of the exception in the last sentence of subsection (e) are applicable. The Corporation in its discretion may provide by regulations or otherwise for the reinstatement in whole or in part, upon such terms and conditions as to payment or otherwise as it may prescribe, of the pro rata share of an institution in the Secondary Reserve in the event that such status or such insurance is restored by action of the Corporation or of a court in reversing or setting aside such termination, or in the event that, after such appointment or such determination, an institution is restored to operation as an insured institution, and for the payment, waiver, or other treatment

in whole or in part of any prepayments which, in the absence of the first sentence of this subsection, would have accrued under subsection (d) or would be payable thereunder.

(g) If, at the close of any December 31, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions but the Primary Reserve does not equal or exceed such 2 per centum, no insured institution shall be obligated to make any prepayment under subsection (d) during the year beginning with May 1 next succeeding such close, and each insured institution's pro rata share of the Secondary Reserve shall be used, to the extent available, to discharge such institution's obligation for its premium under subsection (b) for the premium year beginning in such year; and the suspension of obligation to make such prepayments and the use of such pro rata shares as provided in this sentence shall continue unless and until the next sentence or the last sentence of this subsection shall become operative. If, at the close of any December 31 occurring before the last sentence of this subsection shall become operative, the aggregate of the Primary Reserve and the Secondary Reserve is not at least equal to 1¾ per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions, (i) the obligation of insured institutions to make prepayments under subsection (d) shall resume on May 1 next following such December 31 and shall continue unless and until the first sentence or the last sentence of this subsection shall become operative, and (ii) the use of any insured institution's pro rata share of the Secondary Reserve under the first sentence of this subsection shall terminate with respect to its premium under subsection (b) for the premium

year beginning during the calendar year commencing on May 1 next succeeding such December 31, and such termination shall continue unless and until the first sentence of this subsection shall become operative. If, at the close of any December 31, the Primary Reserve equals or exceeds such 2 per centum, the Corporation shall, at such time (which shall be the same for all insured institutions and shall not be later than May 1 next succeeding such close) and in such manner as the Corporation shall determine, pay in cash to each insured institution its pro rata share of the Secondary Reserve and shall not, after such time, accept or receive further prepayments under subsection (d).

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